



**TO:** Senate and House of Representatives Leadership, Connecticut General Assembly

**FROM:** Thomas J. Welsh, Esq., on behalf of The Connecticut Bar Association

**DATE:** May 7, 2001

**SUBJECT:** SB-1226 – Revised Article 9, Secured Transactions, of the Uniform Commercial Code: Problems from Delayed Enactment and New Non-Uniform Changes  
**PART 1 – Problems From Adoption of Non-Uniform Effective Date**

#### MEMORANDUM

Senate Bill 1226, a Bill adopting the 1998 Revisions to Article 9 of the Uniform Commercial Code, was reported-out of the Judiciary Committee of the Connecticut General Assembly on April 11, 2001. The Judiciary Committee text contained a number of non-uniform changes to the text in the proposed Bill, as well as changes to the text recommended by the Advisory Committee panel established by the Connecticut Law Revision Commission.

Revised Article 9<sup>1</sup> has now been adopted in thirty-five (35) states<sup>2</sup> and the District of Columbia, is pending in fifteen (15) other states<sup>3</sup>, including Connecticut, and is awaiting

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<sup>1</sup> Article 9 of the Uniform Commercial Code (generally referred to herein as “**Article 9**”) states the law regulating security interests in personal property and sales of accounts, contract rights and chattel paper. It states the methods of creating and perfecting security interests in tangible and intangible personal property and the priority rules governing conflicts with the rights of other parties, such as other lien creditors, in property subject to security interests. Article 9 has been enacted by all of the states in the United States and is enacted as part of the Uniform Commercial Code in Title 42a of the Connecticut General Statutes.

<sup>2</sup> States that have adopted Revised Article 9 are Alaska, Arizona, Arkansas, California, Delaware, Georgia, Hawaii, Illinois, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Mexico, North Carolina, North Dakota, Oklahoma, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia and Wyoming.

<sup>3</sup> States in which Revised Article 9 has been introduced and are pending are Alabama, Colorado, Connecticut, Florida, Louisiana, Massachusetts, Missouri, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, South Carolina and Wisconsin.

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Governors' signatures in several of these states. Most states will have enacted Revised Article 9 before the July 1, 2001 uniform date effective in virtually the entire United States.

The purpose of this memorandum is to advise the General Assembly of the “**horrendous complications**” noted by the Drafting Committee for Revised Article 9<sup>4</sup>, which will result from the proposed delay in the effective date in the Bill from the uniform July 1, 2001 date adopted by virtually all other states, and to suggest some partial solutions.

A. **Consequences of Delay or Failure to Enact Revised Article 9**

1. **Conflict of Laws Problems**: Revised Article 9 substantially revises the conflict of laws rules in the current Article 9 to make it easier to determine where to search and file, and minimize the number of filing locations required and instances where new filings are required. The new approach is designed to result in “seamless” transactions over state lines and lower the cost of and impediments to financing and sale transactions, while preserving the important goals embodied in state laws. Revised Article 9 accomplishes this by making matters of perfection of security interests in collateral generally governed by the law of the state where the debtor is located<sup>5</sup> and makes the law relating to the *effect* of perfection and priorities governed generally by the law of the state where tangible collateral is located, as under current law. This conflict of law provision may not be altered by the parties' agreement. Thus, Revised Article 9 will often cause each state to look to the law of *other* states as to perfection of interests in tangible collateral to a far more obvious extent than under the current law. As long as every state has adopted Revised Article 9 there would not be an issue, but issues arise if a state fails to adopt Revised Article 9 in time for the uniform effective date of July 1, 2001 adopted by the other adopting states.

The so-called “conflict of laws” problem in non-uniform enactment of Revised Article 9 is really two problems. The first problem is that the strikingly different conflict of laws rules in current Article 9 and Revised Article 9 will lead to different results depending upon the forum in which the matter is litigated. The second problem results from the different definitions and broader scope of Revised Article 9, which will not be give effect in a jurisdiction that does not adopt Revised Article 9.

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<sup>4</sup> We recognize that this characterization is not very helpful and suggests that the drafters “threw up their hands” at explaining further. This memo also does not pretend to foresee all of the problems that may arise if Revised Article 9 is not adopted or delayed.

<sup>5</sup> Perfection based upon the location of the debtor is the same as under current Article 9 with respect to intangible collateral – but changes where many debtors are located from their chief executive office to their state of organization. However it is unlike current law as to tangible collateral, which generally determines perfection of tangible collateral based on the location of the tangible collateral.

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a. ***Choice of Laws Problems:*** The first problem, arising from different choice of law provisions for perfection of security interests in current and Revised Article 9, is illustrated by the following two situations:

(i) ***Foreign Registered Organization Doing Business In Connecticut:*** A registered organization, such as a corporation, limited liability company or limited partnership, formed under the laws of another state (i.e. Delaware), which has adopted Revised Article 9, and doing business or having collateral in the State of Connecticut will be subject to two different sets of rules depending upon the jurisdiction in which a law suit is brought or in which a bankruptcy case is commenced. If the matter is litigated in Connecticut, or any other state that has not adopted Revised Article 9, the applicable law to test for perfection for ordinary goods would be the jurisdiction in which the goods were located – which, if such jurisdiction had not adopted Revised Article 9, generally requires a filing in the state where the goods are located. However, if the litigation occurs in a state that has adopted Revised Article 9 the applicable law for determining perfection would be the law of the state in which the debtor was formed – which, if such jurisdiction has adopted Revised Article 9, would only require filing in *that* state. The result would then turn on where the action was litigated.

Further, in this example, the debtor, or a creditor with an intervening lien, such as the Internal Revenue Service, could shop for the most advantageous forum to file a bankruptcy proceeding or otherwise to litigate the perfection issue. Another effect would be to allow additional bankruptcy “strong arm” attacks on perfection – directly contrary to the policy of Revised Article 9 to expand the reach of perfection so to preserve security interests from avoidance in bankruptcy.

This strikingly different treatment will create additional preference risks for lenders, lessors of goods, sellers of goods which retained security interests and other parties in Connecticut on whom the State is relying to maintain its economic health. The result will be increased scrutiny and requirements for review by legal counsel of every such transaction involving Connecticut collateral or businesses.

(ii) ***Connecticut Registered Organization Doing Business In Other States:*** A Connecticut corporation or other registered entity doing business in a state which has adopted Revised Article 9 (in the 35 states, such as Rhode Island or Maine, at this writing, and possibly New York, Massachusetts and New Jersey which are expected to pass Revised Article 9 before July 1<sup>st</sup>) will be subject to the following classic conflicts of laws *renvoi* problem. If a challenge to the perfection of the security interest is brought in the state in which it is doing business, or any other state that has adopted revised Article 9, the law will look to Connecticut law to determine perfection – however current Article

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9 in Connecticut will look to the state in which the goods are located (for ordinary goods) or where the chief executive office of the debtor is located (for accounts receivable), which may point back to the state in which the Connecticut corporation is doing business, in a never-ending loop. The problems become even more complex if the chief executive office of the debtor is located in a third state. The clear solution will be for lenders and other secured parties to require, as a condition for financing, that the debtors redomesticate their corporations out of the State of Connecticut and into a jurisdiction that has adopted Revised Article 9.

b. **Different Scope and Substantive Rules Problem:** The second problem, stems from the fact that Revised Article 9 is broader in scope than current Article 9 and has additional methods of perfection, filing requirements and other substantive changes. If Connecticut does not adopt revised Article 9 these substantive changes will not be applicable in Connecticut and certain collateral that business may lend upon, such as commercial deposit accounts, commercial tort claims and electronic chattel paper, will be deemed ineligible for borrowing. Also many transactions, such as syndications or participation transactions will no longer be performed in the State of Connecticut with Connecticut borrowers, but will be moved out of the State of Connecticut and into a state where the rules are more certain. Filing requirements will also be a problem, since lenders to Connecticut borrowers located in other states will not be permitted to file the new national forms in Connecticut, such as the amendment forms and financing statements signed only by the secured party<sup>6</sup>. This will be a trap with respect to Connecticut borrowers and a major inconvenience, since, as noted below, FDIC insured institutions are being instructed by the FDIC to scrutinize all such Article 9 transactions.

2. **Effect of Delay In Effective Date:** The Judiciary Committee's recommended effective date of February 1, 2001 will cause the same uncertainty and complications as if Connecticut had not adopted Revised Article 9, during the seven (7) month "gap" period from July 1, 2001 (when virtually all other states' law becomes effective) until Connecticut's effective date. Under the current Bill, Revised Article 9's "saving clauses", which continue the effectiveness of existing filings during the one-year transition period<sup>7</sup>, will not be effective during this seven (7) month "gap" period<sup>8</sup>. All bankruptcy cases and litigation

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<sup>6</sup> For example, the Office of the Secretary of the State has already issued a memorandum stating that it will not accept the new national amendment form until Connecticut adopts Revised Article 9.

<sup>7</sup> The transition provisions are contained in Part 7 of Revised Article 9 (Sections 126 through 133 of SB 1226). The main "savings clause" is located in Section 128 of the Bill (Revised Article 9 Section 9-702).

<sup>8</sup> If Connecticut allowed the "savings clause" to begin on July 1, 2001, security interests might be preserved until the Connecticut effective date – thereby possibly alleviating some of the delay problems. Under the proposed Bill the Connecticut transition period will also extend beyond the "saving" periods in all other

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instituted in Connecticut or relating to Connecticut businesses during this “gap” period will be subject to the same problems noted above as if Connecticut had *not adopted* Revised Article 9 – resulting in substantial litigation during this “gap” period. This delay in the effectiveness of the “saving clauses” will make the effect of the Connecticut saving clauses uncertain in all but the five (5) month period from the Connecticut effective date to July 1, 2002 – resulting in severely reduced time limit for Connecticut attorneys and businesses to make necessary perfection changes under new Article 9. Another problem under the current Bill is that during the seven (7) month “gap” period the Office of the Secretary of the State will not accept filings under Revised Article 9 relating to Connecticut borrowers until the Connecticut effective date – notwithstanding the fact that Revised Article 9, effective in other states, may require such Connecticut filings – and resulting in significant surprise to Connecticut businesses operating out of state and to other parties relying upon the new national UCC financing statement and amendment forms<sup>9</sup>.

3. **Economic Consequences:** Failure of Connecticut to pass Revised Article 9 or a substantial delay in the uniform effective date will not only have a significant impact upon Connecticut lenders and borrowers, but will also affect a wide range of other Connecticut businesses. Article 9 of the Uniform Commercial Code deals with a broad range of transactions – including financing leases of equipment and sales of goods by Connecticut businesses on credit to buyers. In addition the Federal Financial Institutions Examination Counsel issued a bulletin on February 28, 2001 advising financial institutions of the effects of Revised Article 9 and instructed them, among other things, to review all internal procedures and transactions to evaluate the effect of Revised Article 9 *even in states which have not yet adopted Revised Article 9*. It is clear that Revised Article 9 will have an impact upon the lending of money to Connecticut borrowers, even if Connecticut does not adopt Revised Article 9.

The economic impact on Connecticut from failure to pass Revised Article 9 or from a substantial delay in the effective date was ably described by Attorney Edwin Smith, a NCCUSIL Commissioner and member of the Drafting Committee, in a recent communication, as follows:

[A] delayed effective date for Revised Article 9 in Connecticut will likely create higher transactions costs not only for Connecticut borrowers but also for borrowers from other states that have or might in the future have an office or goods in Connecticut. Few lenders will take the risk that a challenge to the perfection or priority of a Revised Article 9 security interest will arise in a state

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states by seven (7) months – however, since the effect will be to preserve the perfection of security interests, this overlap is less of an issue.

<sup>9</sup> The resulting uncertainties relating to Connecticut borrowers or collateral located in Connecticut can also be expected to reduce the number of out-of-state lenders willing to lend in Connecticut and a resulting decline in competition among lenders in Connecticut.

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that has not enacted Revised Article 9 or will arise in a Revised Article 9 state whose choice of law rule for perfection or priority points to a state that has not enacted Revised Article 9. To protect itself, the lender will need to comply with both Revised Article 9 and former Article 9 (plus, in the case of collateral within the scope of Revised Article 9 but not former Article 9, other law).

The failure of Connecticut timely to enact Revised Article 9 will be especially detrimental in this regard, given Connecticut's importance as a major economic state. To be sure, there may be some transactions that could be structured under Revised Article 9 so as to avoid contacts in Connecticut. For example, one could conceive of lenders insisting that Connecticut corporations reincorporate in other states or exacting higher fees for borrowers opening offices or keeping goods in Connecticut. Whether lenders would take such approaches instead of just incurring and passing on to their borrowers the extra transaction costs of multiple law compliance is conjectural. The point is that a delayed effective date is not a drafting issue; it is an economic issue. Revised Article 9 - with its expanded scope, clearer rules and simplified filing system - offers the opportunity to make more credit available at cheaper cost. The failure of Connecticut timely to enact Revised Article 9 narrows that opportunity for Connecticut's own borrowers and for others as well. This is particularly unfortunate as the economy slows and access to credit becomes more dear.

For the above, reasons, the Board of Governors of the Connecticut Bar Association and its Commercial Law and Bankruptcy and Business Law Sections urge passage of SB 1226 on Revised Article 9 as soon as possible, with a July 1, 2001 uniform effective date. In the event of any delay in the effective date beyond July 1, 2001, additional transition provisions should be added to: (a) maintain the perfection of security interests during the period from July 1, 2001 to the Connecticut effective date – whether such interests are perfected under current Article 9 or Revised Article 9; and (b) add several provisions to authorize the Connecticut Secretary of the State to accept filings under Revised Article 9 as soon as practicable on or after July 1, 2001 and before the Connecticut effective date<sup>10</sup>.

Of course, if you have any questions, or if we can be of further assistance, please do not hesitate to call.

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<sup>10</sup> The March 19, 2001 Judiciary Committee testimony of the Deputy Secretary of the State indicated that the Office of the Secretary of the State could be ready to accept filings under Revised Article 9, provided that Revised Article 9 is passed by the General Assembly in May, to permit them sufficient time to prepare and to implement the system. This testimony indicated that the Office of the Secretary of the State had analyzed the impact of Revised Article 9, knew what changes had to be made to its procedures and computer system and was awaiting authorization from the General Assembly before starting to implement these changes.